INDEX

PAGE

I. Congress Intends to Protect, Not Destroy the Successful Self-assessment System 1– 8

II. "Examination and Investigation" Are Not the Same as "Inspection" 9–11

III. Destruction of Filed Returns by Congress Indicates Legislative Intent to Require Probable Cause for Barred Years 12–14

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1964

No. 12

BAYARD EDWARD RYAN, - - - - *Petitioner,*

v.

UNITED STATES, - - - - - - *Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

REPLY BRIEF FOR THE PETITIONER.

I. CONGRESS INTENDS TO PROTECT, NOT DESTROY THE SUCCESSFUL SELF-ASSESSMENT SYSTEM.

The Government argues (page 14—Powell Brief) that the rule of probable cause would require the agent, before proceeding with an investigation of open years, to establish probable grounds to suspect a deficiency for those years. The Government does admit, as do we, that such is not the case for the open years and it would appear that the reason is found at Section 7602 of the Code, which authorizes the agent to verify the correctness of any return. The applicable words of the Section are as follows:

"EXAMINATION OF BOOKS AND WITNESSES.

"For the purpose of ascertaining the correctness of any return . . ."

It is clear that, during the open years, verification is a routine and authorized check of the return with the books. Also, the necessity may sometimes arise to verify the books with some new fact which has come to the attention of the Commissioner about the income of the taxpayer.

The Government continued its argument by saying that the mere expiration of the three-year statute of limitation in no way diminishes the duty of the Commissioner to determine the liability of any person for internal revenue tax. It must be clear, however, that the statute of limitations indeed does greatly diminish the duty of the Commissioner. For, he would appear to be foolish to send his agents out to make a routine verification of returns for years barred by the statute of limitations, or for a mere verification of the books for such years with some new fact about the taxpayer's income, unless fraud were reasonably indicated. As stated heretofore, it would be unnecessary to verify a return for a barred year merely for the sake of verification. It would be unnecessary to look for additional tax liability for such years unless fraud were probable or reasonably anticipated before beginning. The statute clearly diminishes the responsibility of the Commissioner and he recognizes it.

The Government then further argues by asking that, if probable cause is not prerequisite to an in-

vestigation within the three-year open period, then how can it be required for the years barred and open only for fraud? The Government then says that the "present fraud" investigation falls squarely within the terms of the Commissioner's statutory authorization, and as such can hardly be deemed "unnecessary." The Government then says that this is true because it is necessary to examine to determine if fraud has been committed. It would appear that by using the phrase "present fraud" the Government is thereby assuming and presuming that "fraud" already exists and that the fraud is known or that there is some fact in hand which reasonably indicates that a fraud has been committed by the taxpayer. Thus it appears that the Government has, in a way, acknowledged the necessity of the existence or probable cause to believe that fraud exists to permit the inspection of the taxpayer's books for the barred years. The Government apparently admits that they must have some factual basis to assume and presume that the taxpayer has committed a fraud on the tax. This would appear to be the "necessity" intended by the Congress.

The further argument by the Government is that the Congressional policy to guard against frauds on the revenue is reflected in the severe criminal penalties and the severe civil penalties and, still further, by the Congressional removal of the bar of statute of limitations as to civil fraud. The exact words of the Government are, as follows (Powell Brief, page 15):

> "Our conclusion accords with the clearly defined Congressional policy to guard against frauds

on the revenue, which is reflected in *the imposition of severe criminal and civil penalties* . . ." (Italics supplied.)

The Government continues with the statement that to require the Government to make a showing of probable cause at precisely the time, when the Commissioner most needs his full array of investigative powers, would seriously impair his efforts to detect fraudulent returns.

In the first place, it is confusing, on the part of the Government, to mix in the same sentence a criminal income tax case with a civil income tax case, as revealed by the language found in the Government's brief. To begin with, the taxpayer may stop the Government "cold" in its investigation in a criminal income tax case by the exercise of his constitutional privilege—the Fifth Amendment—and he may, in such a case, refuse to surrender his books and records for examination by the Government agents. Therefore, the Constitution, no less, does what the Government in its brief argues that the Congres should not do—that is, to stop the Commissioner when he needs most his full array of investigative powers.

The argument by the Government as to the criminal case is no more correct and no more convincing that the argument for the civil case. For, it is clear from Section 7605(b) that the Congress intended to stop the Commissioner unless he has some official reason or a probable cause to investigate the taxpayer's books and records for barred years. And, in speaking of criminal income tax evasion, if the Congress in-

tended to be so severe and harsh, as the Government argues, then why did they provide the six-year statute of limitations for criminal fraud which bars forever the prosecution for income tax evasion? Why bring down the curtain at all for the "criminal"? But, why not prosecute him forever rather than just six years?

Further, since evil intent is such an elusive thing, an innocent taxpayer might well refuse to surrender his books if he thinks he may have done something, without evil intent, which he thinks some third party may think was evil. Too, the taxpayer seldom, if ever, understands the refinements of the difference between criminal income tax fraud and civil income tax fraud. What is the difference? It is simply the difference between "beyond a reasonable doubt" and "a preponderance of evidence." Would the ordinary taxpayer know the difference? We think not. If a taxpayer has had evil intent and has filed a fraudulent return, if he is advised or so wishes, he may plead the Fifth Amendment and not surrender his books or talk to the agent. If a taxpayer has not been fraudulent, then he should never be bothered and his books should never be demanded by the agent since he can not be liable for additional taxes for the barred years.

The backbone of the Federal income tax system is the self-assessment by the taxpayer when he prepares and files his return. Each taxpayer assesses himself when he prepares and files his return. The whole system is based on and depends upon this self-assessment. The success of the Federal income tax collections and system depends on this self-assessment. Too, it is

predicated on the belief that every taxpayer, with extremely rare exceptions, is honest and files an honest return. The system is based also on the position that the honest taxpayer should not be harassed and badgered but that he should be protected and encouraged. The law as passed by Congress in Section 7605(b) (as well as 7605(a)) is designed to protect and to encourage the taxpayer in his honest self-assessment. And, the verification of the income tax return by the Commissioner as provided by Section 7602 is designed to determine if the taxpayer has correctly assessed himself. If the taxpayer has erred in his self-assessment, in preparing and filing his return, then the return is corrected and the additional tax is collected or the overpayment is refunded. It is therefore clear that the main goal of the inspection by the Commissioner of the taxpayer's books is to verify or ascertain the correctness of the self-assessment.

Further study of the Internal Revenue Code reveals the protection and encouragement intended by the Congress. For instance, there is a three-year statute of limitations, after which period additional taxes are barred with two exceptions (Section 6501). First, the years are open for six years where there is 25 per cent omission of income and this is without the need of proving fraud (Section 6501(c)). Second, where there is fraud the statute never bars the collection of additional taxes. So long as the three years are open, additional tax may be collected without fraud or the 25 per cent omission. From three years to six years, additional taxes may be assessed and collected by show-

ing that the taxpayer omitted 25 per cent of tax or, if no omission of 25 per cent, then only if there is fraud. After six years, however, the "curtain is drawn" completely except and save only in the case of fraud.

During the first three years, when the years are not barred, the Commissioner has the great benefit and advantage of the presumption of the correctness of his determination. The Commissioner need only set up additional tax for the open years and his determination is presumed to be correct. The taxpayer then has the burden of proving that the Commissioner erred. It is therefore clear that the Congress makes it more difficult for the taxpayer during the open years than at any other time.

Congress, in passing the statute of limitations, has however made it more difficult for the Commissioner after the three years expire, that is, during the barred years. For then, the Government has the burden of proof of the 25 per cent omission. The Government also has the burden of proof of fraud. For instance, the Government has the heavy burden of proving both of the following:

(1) A *bad return* filed, and
(2) An *evil intent* in filing it.

The heavy burden placed on the Commissioner, during the barred years is seen by the fact that he does not meet his burden where the following exists:

(1) a bad return (2) but a good intent
(1) a good return (2) but an evil intent

A bad return means that it must have omitted tax, however an erroneous return alone is not sufficient

but it must have been filed with evil intent. The most evil intent in the world, as to a filed return, will not help if the return reports all (or more) of the income tax which the taxpayer owes from all of his income.

Admittedly, if the Government succeeds, however, in proving fraud, the penalties for the taxpayer are severe, as follows:

(1) Criminal fraud—penitentiary sentences and fines
(2) Civil fraud—penalty of 50 per cent of additional tax

A taxpayer will be subjected to the civil fraud penalty if he is found guilty of criminal fraud. He can be subjected to the civil fraud penalty without being subjected to the criminal penalty.

It would appear that one of the main purposes of Congress in providing the statute of limitations (the three year and the six year) is to arouse and push the agent to expeditiously examine during the three open years, when the burden of proof as to additional tax is on the taxpayer and not on the Government. It is clear that one of the main purposes of the Congress in providing the clause "no unnecessary examinations and investigations," found at Section 7605(b), was to further arouse and push the agent into the completion of all examinations during the three open years and not to have him wait to begin, after the years are barred. In other words, it is clear that the Congress has provided that the open season for "fishing" or verification is during the three open years.

II. "EXAMINATION AND INVESTIGATION" ARE NOT THE SAME AS "INSPECTION."

A study of certain of the language of Section 7605(b) would further appear to reveal the true intent of the Congress. This language is as follows:

> ". . . and only one *inspection* of a taxpayer's books of account shall be made for each taxable year *unless* the taxpayer requests otherwise *or unless* the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional *inspection* is necessary." (Italics supplied.)

Thus it says and means that a second inspection may be made only if the taxpayer requests or that the Secretary or delegate, after investigation, notifies the taxpayer that a second inspection is necessary. That is, the Code says, as to the wishes of the taxpayer, a second "inspection" of the taxpayer's books shall not be made *"unless"* and only *"unless"* the taxpayer requests. Now, it says only one inspection unless the taxpayer requests a second inspection. In other words, the taxpayer may request a second *inspection*, however he would only make such request, when and if the years were open. That is, he would request only for the three open years because he would request only when and if he had overpaid his taxes and could recover the overpayment, of if he had underpaid and the additional tax could be assessed and collected by the Commissioner. The taxpayer would never request a second inspection for barred years for the sole purpose

of determining an overpayment or underpayment of tax for those years.

Since the above two (unless) exceptions to the rule, that only one inspection may be made of the taxpayer's books are linked together in the same clause, it would clearly appear that the Congress intended that this authorized second inspection should only apply to the open years. That is, since it appears that the taxpayer was expected to ask for another inspection only as to the three open years, therefore Congress must have intended the same to be true as to the request by the Secretary or his delegate for a second inspection.

The words "examination and investigation" as used in the first part of Section 7605(b) carry a very different meaning from the word "inspection" as used later in connection with the books of the taxpayer. It is clear that the Congress did not intend, as the Government argues, that the words mean the same thing. The words "examination and investigation" certainly do not mean *repetitive inspections* of the taxpayer's books. The words "examination and investigation" take into account the whole rampart of the determination of the correctness of the taxpayer's filed returns. These words, as commonly understood, cover the activity of the agent from start to finish of his case, as it applies personally to the taxpayer. If the Congress had not so intended, they would have used the phrase "unnecessary inspections" instead of "unnecessary examinations and investigations." The word

"inspection" as used here, applies solely to the books and means the "looking" at the books.

Too, the word "unnecessary" as used here by the Congress is said by Webster's dictionary to carry a meaning of "needless, useless, or not required under the circumstances." It would clearly appear that the Congress intended that the word "unnecessary" carry its commonly accepted Webster dictionary meaning. The obvious meaning here therefore, where Webster says "not required under the circumstances," is that the Secretary or his agent must have a reasonable basis to suspect fraud to entitle him to inspect the taxpayer's books for the barred years, open only by fraud. As Mr. Justice Douglas once observed, "Whatever the reason, words mean what they say."

Further, it may well have been, as the Government argues, that the Congress hoped and intended that the requirement, that the Secretary write the taxpayer that a second "inspection" of his books was necessary, would be sufficient administrative control of the agent to allow the taxpayer his deserved peace of mind. It may well have been thought that this would lead to an end of repetitive inspections of the taxpayer's books and the end of the frivolous and oppressive inspections of the taxpayer's books.

III. DESTRUCTION OF FILED RETURNS BY CONGRESS INDICATES LEGISLATIVE INTENT TO REQUIRE PROBABLE CAUSE FOR BARRED YEARS.

It is a matter of law that Federal income tax returns may be destroyed by the Commissioner upon the approval of Congress. And, authority has been granted by the Congress from time to time for the Commissioner to destroy returns, the most recent of which authorizations are found in House Reports No. 2285, 84th Congress, Second Session; No. 819, 85th Congress, First Session; No. 690, 86th Congress, First Session; and No. 1175, 86th Congress, First Session.

It would therefore appear from these reports that, pursuant to this Congressional authority, the individual returns for the years prior to 1956 generally have been destroyed. If Congress intended that all books and records be kept forever, they would not therefore authorize the destruction of the original returns filed by an individual taxpayer. Further, when the original filed returns are destroyed, how can the Commissioner or his agent verify a return which he does not have? How can he determine whether or not the taxpayer has filed a correct return?

The Congress does not intend that the return, for barred years open only by fraud, be examined except where the Commissioner or agent has a reasonable basis to suspect fraud. It would clearly appear that the Congress, in ordering the destruction of the filed returns, recognizes that the honest taxpayer is entitled to a peace of mind and that in using the words

"unnecessary examinations and investigations" it was intended that this peace should be disturbed only when there was probable cause to suspect fraud.

Assuming that the agent submitted his basis for a suspicion of fraud and the District Court refused him, even without his demanded inspection of the books, the examination and investigation by the agent of the taxpayer would surely continue, that is, if the agent had in hand facts which revealed a reasonable basis of a suspicion of fraud to warrant the continued examination. The mere fact that the agent could not inspect without showing a reasonable basis, does not mean that the agent may never look at the books. Because, if he, the agent, has something more than a mere personal desire to "fish," then he can send the taxpayer a statutory notice, and then he, or the Appellate advisor of the Treasury, can demand to know the content of the books before settling the case. Or, in the event of trial in the United States Tax Court, the Treasury counsel may subpoena the records, which would require the taxpayer to produce his books in court for the inspection of the counsel and the agent. If there is evidence of fraud in the books, then that fraud will be revealed.

It is therefore eminently clear that the interpretation here asked by the taxpayer will not interfere in any way in the enforcement of the civil penalty for fraud. It will, however, stop the harassment of the honest taxpayer by an unscrupulous agent. And this was surely the purpose of Congress in using the words,

"the taxpayer shall not be subjected to unnecessary examinations."

The facts of the instant case present the very situation which the Congress had in mind when Section 7605(b) was written into law. The Congress will not tolerate the harassment and hounding of honest taxpayers such as in the instant one, solely for the primary personal purpose of the agent. It must be always that the Commissioner or his agent has a reasonable basis of suspicion of fraud when he begins an examination of barred years, otherwise the examination would not have been started. Their good judgment would normally be presumed. The only instance when there would be no reasonable basis would be where the agent had a personal motive—an evil motive—perhaps, a motive of personal vengeance in making the examination. Otherwise, the examination would never have been begun without a good cause.

The Congress also recognized that, where the agent is arbitrary and wrongful, it is almost impossible for the taxpayer to be able to prove this evil on the part of the agent. The Congress obviously realized that the best evidence of evil by an agent was a showing that he had no real purpose in making his examination, that is, that he had no reasonable basis to suspect fraud.

WILLIAM R. BAGBY,
1107 First National Building,
Lexington, Kentucky,
Counsel for Petitioner.

October, 1964